$40.00 ANNUALLY
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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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HOT? It is much easier to shout or insist than to discuss. Perhaps I have taken the difficult path in these Letters, but in my opinion, successful investment procedure depends on knowledge--not dogma. Of all market concepts the one concerning the mechanics of a primary reversal seems most difficult to understand. The greatest single cause of incorrect selling during a primary bull market is fear - fear of war news, fear of politics, fear of bearish pronouncements, fear of high stock prices, fear of recessions, and fear of change. Yet none of these have ever turned the primary trend of a great bull market. The trader, in contrast to the long-term holder, will occasionally gather profits during a bull market. But these profits are generally taken near the highs of a long, uncorrected advance (amid great bullishness), when the averages themselves give warning of a possible reaction. At such times the experienced trader may elect to pay the cost of "insurance" (taxes and commissions) in the hopes of repurchasing his stocks later at lower prices. Most traders will continue to hold large portions of their portfolios, however, as long as they are convinced that the primary trend is up.

On November 2, 1945, Rhea wrote regarding that bull market: "Diagnosis might be improved somewhat if we could all agree on how hot is hot." The conditions which accompany a turn in the tide are, in my opinion, now beginning to appear in name - but not in degree. Reversals from bull to bear markets usually occur during periods of rampant speculation, tremendous optimism, excellent business statistics, and wide public participation. All four of these have recently appeared in varying amounts, but so far they have been tempered with intermittent doses of caution. Neither the volume (to date), the short interest, nor the relative quantity of odd-lot buying points to the type of public participation which I would expect at the final culmination of the greatest bull market in history.

Bull markets expire under cloudless skies while amateurs are busy selling stock to each other and experienced operators are hauling in their sails in preparation for the storm ahead. The investor who has been holding stocks for years - through the ups and downs of a long primary movement - likes nothing better than a bullish and even greedy crowd. The crowd is always his best customer, and an idyllic business outlook puts this customer in a buying mood.

CAUTION. The last month or so has brought forth a barrage of cautious pronouncements from such diverse organizations as the N. Y. Stock Exchange, Life Magazine, the Wall Street Journal, and leading investment services. The public and Wall Street, never quick to adjust themselves to new conditions, are skeptical of the high level of security prices. Yet prices themselves do not make a bear market, particularly when accompanied by a general attitude of disbelief. One broker (quoted in the April 24 N. Y. Times) found the market "acting under the burden of trying to prove that the present situation is real." I suspect that this same broker will be "believing" at about the time that this bull market is topping out.

"I have noticed," wrote Hamilton, "that the really successful man in Wall Street is curiously inarticulate. Experience has taught him to keep his tongue between his teeth." In other words, Hamilton (who knew most of the successful men on Wall Street) also knew that these informed investors do their selling without benefit of advertising or brass bands. But we can be sure that about the time that the successful investor is distributing in earnest the analysts will start believing their own predictions, and another "New Era" will be

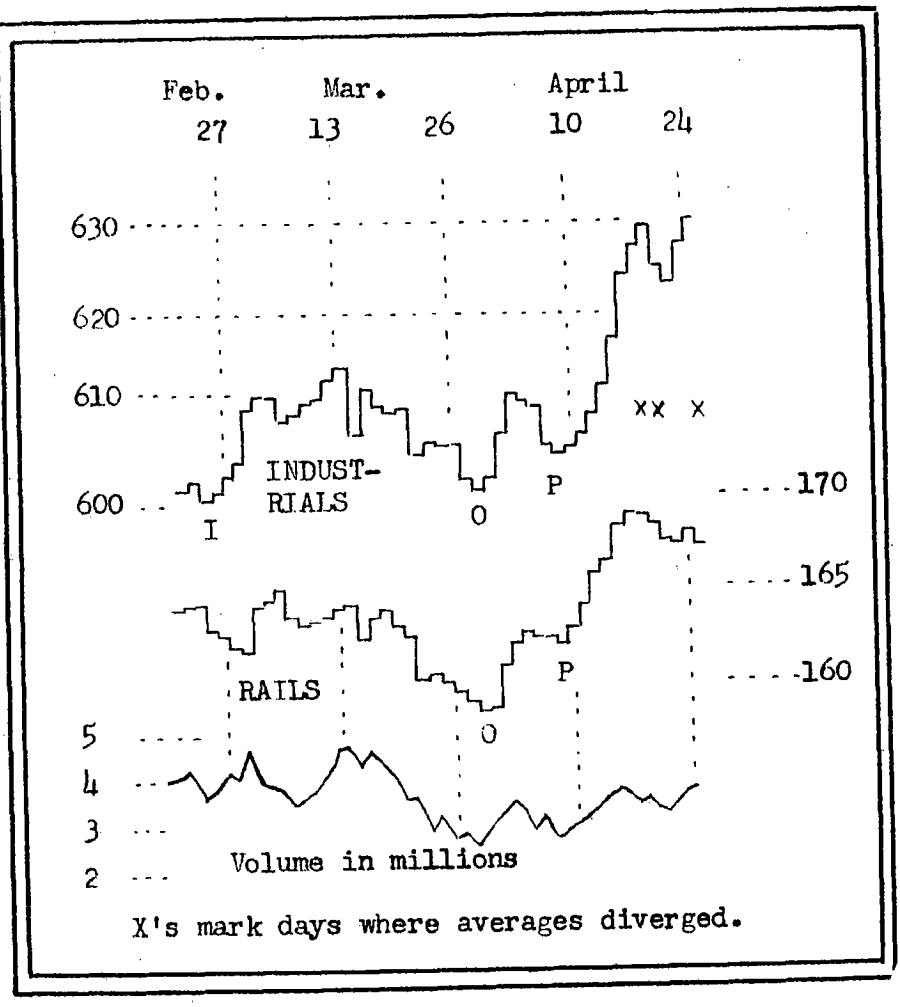
exhumed. I sincerely hope readers of these Letters are immunizing themselves against this sort of thing, because it is obvious that the groundwork is being laid at this time.

THIRD PHASE STUDIES - THE END OF THE 1903-06 BULL MARKET. Letter 57 contained the first in a series of third phase studies - the story of the 1899 bull market top. Following is the history of the 1906 affair. This highly speculative bull market began in 1903. During the next few years, says the historian Alfred Dana Noyes, "...prices and the cost of living rose with greater rapidity than any time in a generation past." He continues: "Belief in impregnable prosperity was general, and with that belief came not only lavish private expenditure, but appetite for speculation. Newspapers of 1905 were full of advertisements of mining, oil, and miscellaneous ventures....people were apparently determined to speculate, and even in the villages, the talk of 'tips' and 'sure things' was of constant recurrence in everyday conversation." 1906 saw "...markets in four continents plunging simultaneously into speculation, at the very moment when trade demands were at a maximum, and when the Manchurian War had drawn in such prodigious sums on the world's capital reserves."

A high volume (up to 4 million shares per day) advance ended in April, 1905. Following the secondary reaction which corrected this advance, the averages rallied again, then flattened out to form a long "line" which lasted from August to December, 1905. It is usual for the last line in a bull market to be broken topside, and although technically this implies accumulation, it is accumulation by the crowd and distribution by informed investors. Subsequent to the topside breakout of the line in 1905, both averages advanced to new highs which were hit in January of 1906. Despite the bullish atmosphere throughout the country, volume dropped off as these highs were approached. A long (4 month) reaction followed, and any investor who did not sell out here was hopelessly optimistic. After the "reaction" the averages rallied on low volume but failed to better their previous highs. Another long line formed from August to December of 1906. When this line was broken downside the "Panic of 1907" was on its way. Rails (the higher priced average in those days) lost all their bull market gains during the next 11 months.

A glimpse of the aftermath of the 1903-06 prosperity runs as follows: "In June (1907) an $8,000,000 iron-manufacturing house went down at N.Y.C.; in midsummer two N.Y.C. loans, offered for public subscription, failed to find a market; in early autumn, the $52,000,000 N.Y. street railway combination went into receivers' hands, followed a few weeks later by the $34,000,000 Westinghouse Electric Co.; early in October the storm broke with the utmost suddenness and violence on the N.Y. banks." (A.D.Noyes - "Forty Years of American Finance").

PRICE MOVEMENTS - NEAR TERM. Despite the strength which was implied by the breakout of the long "line" (see Letter 63), a few factors have cropped up during the last week or so which bear discussion. I mentioned in Letter 63 that despite the obviously bullish pattern of the averages, volume had so far been lacking on the advance. I had hoped that volume would bullishly increase as the advance progressed, but (up to this writing) we have not seen a single four million share day. It has been two weeks since the line was broken upside, and it seems to me that more buying power should have been witnessed. Another element of possible concern is that we have had three days of divergence (the two averages moving in opposite directions) out of the last seven trading days; this is a signal for caution--and one that should never be ignored. On Monday (April 27) as industrials swept to new all-time highs, rails dropped 78¢ in a most hesitant manner. There is no doubt that rails are in an area of heavy supply, and the final move through the 181.23 highs of 1956 will be difficult to accomplish. As rails enter the present lofty area, thousands of rail-holders who were previously locked in with losses are undoubtedly selling and switching into other groups. Nevertheless this does not explain the divergence in the two averages, particularly since rails only recently bettered their January highs (167.38) after many months of plodding work.



I have mentioned that successive penetrations in a maturing bull market hold increasingly less validity as far as bullish signals are concerned. This is particularly true of the current line penetration which was accomplished after an uncorrected advance of over 200 points. On April 16, industrials bettered their previous highs to confirm the breakout of the rails two days before. Under Dow Theory, when previous highs are bettered by both averages and the primary trend is confirmed or reaffirmed, the significance of all previous lows is erased. The strength of the market can now be determined only by the action of the averages following the next decline. Dow Theorists know that every advance or decline is entitled to a 1/3 to 2/3 correction. Therefore it would now be entirely normal for the two indicators to retrace 1/3 to 2/3 of the advance from the recent line area. Rails have already done more than this (with disheartening ease), and industrials could easily do the same. Subsequent to the decline, if both averages then rally and better their recently established highs (industrials 629.87; rails 168.92), preferably on increasing volume, the all clear signal will have been given and we will take the upward trend as continuing. However, once the decline lows are established, if the two averages then rally on weaker volume and one or both averages refuse to better the aforementioned highs, the danger signals will be flashing. If the two averages then turn down and they both violate the lows of the decline, particularly on increasing volume, the chances of a further decline or perhaps a reaction of indeterminate depth will loom as an excellent possibility. In this case, traders who wish to protect profits may elect to lighten holdings as "insurance" against this possible reaction. As for long-term investors, they can make their decisions in the knowledge that the primary trend of stocks and the economy continues to point up.

The latest short interest figures show another drop in the total short position, which now stands at 3.5 million shares. The S.I. ratio is 1.02, which is about neutral. 3.5 million shorts, however, is still an impressive number to be betting on a collapse in a bull market; seldom have so many been correct. (Written 4/28/59 - 4 p.m.)

STOCKS. The aircraft group has seen some violent changes. NORTHROP, recently recommended has not worked out, BOEING and UNITED AIRCRAFT show technical weakness. RADIO CORP., BECKMAN, WESTINGHOUSE, HERCULES POWDER, DOW, WHITE MOTORS, CHRYSLER, MONSANTO, OLIN MATHIESON, HOFFMAN ELECTRONICS, GENERAL TIRE, all recent suggestions continue to look good and should be held. The airlines have been heading lower, and this group has been a real disappointment. Would continue to hold these, however, in hopes of a turnaround. MAGMA, ANACONDA, AMERICAN SMELTING, although selling off on low volume, do not look strong. STANDARD of N.J. and ROYAL DUTCH, showing little after their recent hopeful charts, may be held on the hopes that the worst has been seen. In general, I would not make new commitments in this area except for a few low-priced numbers like ALLEGHENY CORP., BALDWIN-LIMA, AMERICAN CABLE, which can be bought for accounts which are desirous of adding a few speculative numbers.

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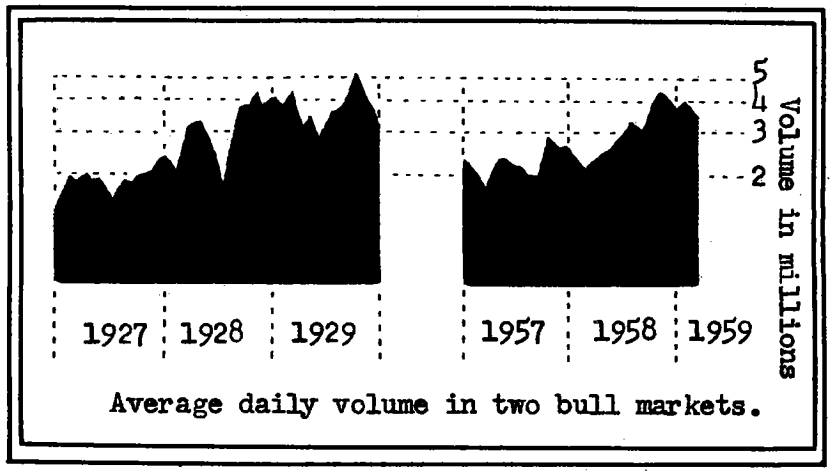
EVERYBODY IN? Volume can be likened to steam pressure in a boiler - the greater the pressure the more power generated. I have often stated that the 1921-29 bull market is the only market in any way equal to the present one in duration and extent. For this reason comparisons are valid. In Letter 60 we discussed the fact that so far in this bull market volume has lagged behind 1921-29. A study of the volume chart below will bear this statement out. The third phase of the 1929 bull market began in 1927 and extended into September, 1929. Considering that the total population was about 122 million in 1929 and that the '29 market topped out at 381 on the D-J industrials, there are excellent reasons for saying that this former market was smaller in many ways than today's massive structure. The present bull market has advanced the D-J industrials to 630 at a time when the total population is over 175 million. Although margins are now 90% against 10% in 1929, few people realize that individual savings in 1929 were 50 billions against about 270 billions today. For this reason I believe volume comparisons are valid.



Average daily volume in two bull markets.

During late 1928 and a good part of 1929 (see chart) volume was averaging four million shares per day and better. Many weeks saw strings of 5-6-7 million share days as the public poured in for a final slice of the "New Era". If the current third phase is taken to have started in October, 1957, we have had only a small period which compares to 1928-29 in average volume. This was the final few months of 1958 and one month in 1959. Even here no single day ever registered as much as six million shares. In my opinion the pressure under the current boiler could go a lot higher before the final topping-out. Great bull markets have a habit of fooling the bears, and the final phase of a bull market is more a study of mass emotions and greed than logic or values. I am not convinced that human nature has changed in the past thirty years - only time will tell.

QUESTION. With the tremendous buying power which the institutions possess today, how can there ever be a collapse in security prices comparable to previous bear market collapses? Wouldn't the funds protect their investments? (H.L.O., N.Y.C.)

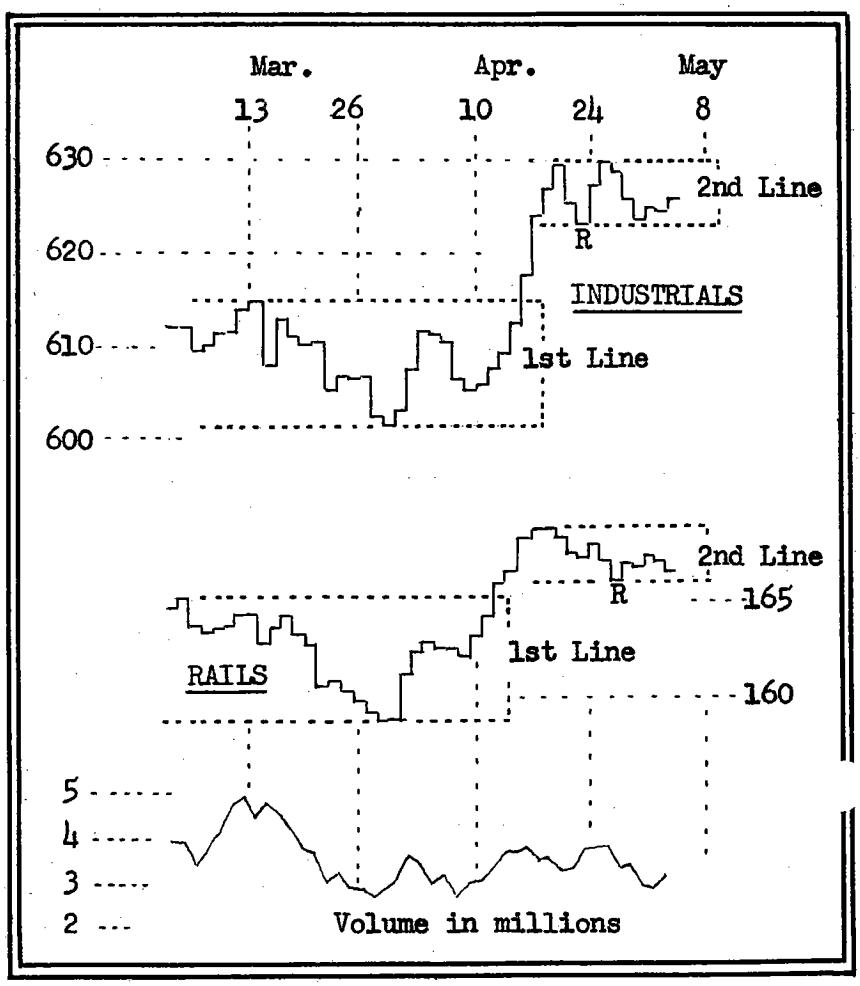
ANSWER. The total value of all stocks listed on the N.Y. Stock Exchange (forgetting the other exchanges and the unlisted securities) runs about $280 billions. Of this amount the institutions (of all types) hold about 16.3% or about $45 billions in actual value. According to the prevailing argument, on the advent of a turn in the tide the institutions would be expected to gather up whatever stocks might be thrown on the market and thereby hold up prices; in so doing they would also be manipulating the primary trend of the market. But the implications of such an act are interesting. If the institutions doubled their entire current investment they could pick up only 20% of the $235 billions worth of the stock outstanding in hands other than their own. Yet one minor factor must be discussed. Mutual funds hold $10.2 of the $45 billions of stock owned by all the institutions. If security prices turn down and redemptions of mutual funds begin to out-balance purchases, instead of being able to buy additional stock the funds would be required to sell! It seems to me that the whole thesis of the

institutions being able to hold up stock prices after a bear signal is given can be likened to a baby with a beach pail trying to hold up Niagara Falls. It might work, but I would prefer to watch the show from dry land.

PRICE MOVEMENTS - A NEW "LINE". For four months the market has acted like a girl who can't make up her mind. A line was formed from February 25 through April; it was recently broken upward on unimpressive volume. The net result was an advance of 15 points for industrials and 5 for rails. In rallying, the rails finally bettered their January highs, thereby confirming the industrial highs. Since April 19 the industrial and rail averages have fluctuated between respective highs of 629.87 and 168.92 and respective lows of 623.27 and 166.08. Thus in this latest period of evenly matched buying and selling, the averages have ignored the excellent and obvious business statistics and formed another line of appraisal. They seem to be remembering Hamilton's words to the effect that the stock market "..is based not upon surrounding conditions but upon what may be expected as far ahead as the combined intelligence of the market can see."

Dow Theorists know that a dual penetration through the line's upper limits will be a prediction of higher prices and continuing good business while a penetration of both averages through the line's lower limits will be a prediction of lower prices and perhaps business troubles ahead. Two things will heighten the importance of a final penetration: (1)- increased volume on the breakthrough, (2)- simultaneous penetrations by both averages or at least penetrations of the two averages within a few days of each other. Note that the lower line limits were formed by the decline lows (point R on chart) which were mentioned in the last Letter. In areas such as this one, Dow Theorists are prone to lay the newspapers aside, ignore the analysts and the business statistics, and wait patiently for the "verdict of the averages".

DANGER SIGNALS to watch for: (1)- one average bettering the line limit while the other persistently refuses to follow, (2)- diminishing volume on a topside breakout of the line, (3)- divergence (the two averages moving in opposite directions) following a topside breako. (4)- and most important, a breaking below the line limits by both averages on increasing volume. In this event traders can protect themselves by taking profits. Long-term investors can hold their stocks on the basis of the primary trend's continuing to point up. (Written 5/6/59 - 6 PM)



STOCKS. Subscribers who were lucky enough to glean any of the following stocks out of our past few months' selections are showing profits: Emerson Electric, Beckman, Hoffman Electronics, General Tire, Dow, Radio Corp. But for most it has been a difficult 1959. As mentioned recently, fewer and fewer impressive "buy" charts are showing up in my collection. Ideal charts show an area of good accumulation prior to or just after a breakout. These formations are hard to find now and many stocks seem to have been moving out of sheer momentum. RAYTHEON, DOW, and ROBERTSHAW-FULTON look good on the charts, but because of the uncertain character of the market I continue to follow last week's policy of recommending no purchases.